

TEACHERS' RETIREMENT BOARD
BUDGETS AND AUDITS COMMITTEE

SUBJECT: Internal Audit Final Report
Securities Lending Program

ITEM NUMBER: 7

ATTACHMENTS: _____

ACTION: _____

DATE OF MEETING: April 6, 2000

INFORMATION: X

PRESENTER: Way Lee

We completed our audit of the California State Teachers' Retirement System's (CalSTRS) Securities Lending (S/L) Program, which was established in 1988 and is administered by the Investments Branch. We conducted a comprehensive preliminary review of the Program including an analysis of the internal control system. We also performed testing of the controls in some of the higher risk areas. Based on the results of our audit, we formed the opinion that an adequate system of internal control has been established for the S/L Program. However, we did identify several issues that require corrective action and we identified areas where the control system could be strengthened to further mitigate risk exposure.

Our recommendations for improvements focused primarily on the Investments Branch staff's monitoring and reporting activities. We also recommended developing formal procedures or guidelines for some activities and made suggestions for enhancing lending agent contracts. In order to implement some of these recommendations, management may need to consider allocating additional resources to the S/L Program.

Our audit observations and recommendations, as well as management's response to the issues, are summarized below within four broad categories: monitoring, reporting, procedures, and agent contracts.

Monitoring: Investments Branch staff could improve upon existing monitoring activities and provide more oversight of CalSTRS' S/L agents' compliance with contract and program policy requirements. Some agents do not consistently adhere to requirements for daily collateral margin maintenance, do not submit required financial reports, and do not provide sufficient evidence that they regularly reevaluate their borrowers' creditworthiness. Staff should more thoroughly monitor agents' reports of S/L Program results by reconciling summary data, verifying the accuracy of data, and evidencing their follow-up of irregularities. Furthermore, staff does not provide adequate documentation to evidence that they are effectively utilizing the monitoring services provided by

CalSTRS' S/L consultant and does not take steps to ensure that the consultant submits reports in a timely manner.

- **Response:** *Management agrees that monitoring activities could be enhanced and more thoroughly documented. Agents' daily collateral value reports are now being more efficiently tracked and monitored. Staff is implementing a new monitoring system to track, review, and evaluate agents' financial documents and other required reports. Staff are developing a more standardized format for agents to report borrower listings. Agents have been directed to perform monthly reconciliations with the master custodian's records and to submit copies of audit reports covering their internal controls over their management of cash collateral portfolios and income reconciliation processes. The consultant's delay in submitting past reports was due to staffing issues and the status of reports is now being more closely monitored. Monitoring efforts, including follow-up of issues/irregularities identified within internal and external reports, will be more fully documented. Management intends to assign additional staff to the program in order to perform some of these duties.*

Reporting: The myriad of reporting formats used by S/L agents makes it difficult for CalSTRS' staff to accurately summarize data for its reporting purposes. Consequently, errors were made in reporting monthly Program results to the CIO and to the Investment Committee. Additionally, the CIO should consider modifying the format of his report to the Investment Committee to include monthly earnings results to provide more consistency within the report format.

- **Response:** *Management agrees that standardization of agents' reporting formats would simplify the oversight of the S/L Program. Staff will develop standardized formats for the agents once the new contracts are put in place subsequent to the Request for Proposal (RFP) process. Previous reporting errors have been resolved and corrected. Regarding the format of the CIO's Off Balance Sheet Transactions Report, the format being used to present data was requested by the Investment Committee.*

Procedures: Staff should develop new procedures or guidelines or enhance existing procedures for some key processes. For example, more specific guidelines are needed to address activities involved with managing the cash collateral portfolio. Also, once CalSTRS utilizes the agent pool concept, formal instructions should be established to ensure that the custodian holds back a portion of all loanable assets. Finally, staff should ensure that the procedures regarding the recall and voting of loaned securities remains within CalSTRS' Corporate Governance manual or are included within the S/L manual.

- **Response:** *Management agrees that written procedures are essential to the risk control process. The Fixed Income unit will maintain a written Desk Manual, which will document workflow and processes that relate to the written procedures for the S/L Program. Procedures regarding the recall and voting of loaned securities will be included within either the S/L manual or Corporate Governance manual and staff will continue to ensure that a portion of loanable securities are held back.*

Agent Contracts: CalSTRS should standardize and enhance the language within its lending agent contracts. Currently, agent contracts vary with regard to earnings requirements. Contract indemnification clauses regarding borrower defaults and clauses addressing agents' sharing in investment risks need to be strengthened. Also, agents' reporting formats need to be standardized. Furthermore, more specific guidelines could be provided to agents regarding their mark-to-market activities, borrower selection criteria, and management of cash collateral investments.

- **Response:** *Management agrees that agent contracts and reporting formats should be standardized. Existing contracts were put in place at various times over the past ten years. The current RFP process and upcoming program restructuring will enable staff to enhance the standardization of agent contracts consistent with approval policy. When negotiating new contracts, staff will continue to seek all opportunities to mitigate risks associated with S/L. Agents are using a new process for transmitting daily data to CalSTRS regarding their collateral levels. Although management does not feel that guidelines are warranted to direct agents regarding their borrower selection criteria, staff is developing a more standardized format for agents to submit their borrower listings. Management is reluctant to dictate specific investment guidelines to agents since it could hinder agents' abilities to implement their own investment strategies. Staff will continue to closely monitor agents' investment activities and document their monitoring efforts.*